

A New Era Of Regulation Has Already Begun

From the CFTC to Congress, actions and proposals are transforming derivatives markets.

By Gregory Mocek & Athena Velie

IN THE RECENT financial market upheaval and credit crunch, major investment banks, hedge funds and commercial trading organisations worldwide succumbed to risk from the trading of derivatives, even though these institutions were among the most sophisticated users of risk management methodologies and systems. The result fueled a groundswell belief that more government regulation is necessary to regulate futures and derivative trading.



President Barack Obama's choice to head the Commodity Futures Trading Commission (CFTC), Gary S. Gensler, recently hinted at his regulatory policies for the CFTC when he said that he looks, "... forward to working with

Congress ... in considering greater oversight and consistent regulation, where appropriate, for all markets relating to commodities." He further noted that he would, "... ensure that the CFTC fulfills its statutory mission to guard against excessive speculation" in the commodity markets.

Gensler was a key adviser to Senate Democrats in helping to draft the 2002 Sarbanes-Oxley Act. A turn toward more regulation by the CFTC thus seems likely. In a letter to Senator Carl Levin (D-MI), on January 26th, Gensler made his intentions quite clear when he said, "I support stronger regulation of US commodity markets."

That trend was already underway even before Gensler's nomination. In November 2008, Walt Lukken, who was then the CFTC's acting Chairman, proposed broad changes to the financial regulatory structure that would have significant implications for the financial markets, particularly for participants in currently unregulated over the counter (OTC) markets. Unlike some who have called for combining the CFTC and the Securities and Exchange Commission (SEC) into a super-regulatory group, Lukken proposed a new regulatory framework to replace the CFTC, the SEC and the banking regulators. He suggested creating three new regulatory bodies, namely:

- **Systemic Risk Regulator** – to police the entire system and provide damage control in light of the inter-connectedness of the financial markets and the speed with which a crisis can spread.
- **Market Integrity Regulator** – to oversee the "safety and soundness" of exchanges, investment firms and commercial banks (institutions whose failure could jeopardize the integrity of the markets).
- **Investor Protection Regulator** – to oversee investor protection and business conduct across all market participants.

Centralised Regulation

Lukken's proposals reflect outside-the-box thinking compared to numerous proposals already made in Congress. There are many who view such steps as necessary to counterbalance the reduced regulation of OTC markets following enactment of the Commodity Futures Modernization Act of 2000 (CFMA). Undoubtedly, the CFMA fostered explosive growth in US commodity markets. During

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the past few years, market participants developed hundreds of novel derivatives products that are now traded both on futures exchanges and OTC markets. Unlike the SEC, the CFTC truly opened domestic borders to foreign boards of trade, and allowed market participants to build massive proprietary portfolios of cleared and

non-cleared derivatives contracts that, prior to the recent credit crisis, were valued in excess of the gross national product of some of the largest nations in the world.

Now, however, many in the halls of Congress want to restrict the former market-based approach with dramatically more regulatory oversight. Catchwords like ‘enhanced safety,’ ‘accountability,’ and ‘transparency’ are replacing former open-market era phrases such as ‘fostering innovation’ and ‘legal certainty’. The subprime crisis that led to today’s financial market turmoil has already resulted in moves to regulate the mortgage origination business, left banks dealing with capital issues, increased the scrutiny of the credit rating agencies, and caused most regulators to call for clearing in the credit default swap (CDS) market. The recent problems in the CDS market exposed the entire bilateral uncleared swap market – which includes swaps traded on everything from electricity to interest rates – to an environment that will result in more centralised clearing for many OTC derivatives contracts.

Possible Changes

In an attempt to get out in front of potential OTC market legislation and appear proactive, during the summer of 2008, the CFTC issued a special call to 32 entities that are major swap dealers and commodity index funds. The special call requested data that reflected their trading activity in the futures and OTC markets. The special call was essentially a survey to determine:

- 1) The volume of commodity index trading in both the OTC and on-exchange markets.
- 2) The volume of commodity index trading by commodity in those markets.
- 3) The types of index investors.
- 4) The types of clients that trade in the OTC markets using swap dealers.
- 5) Whether the OTC positions of swap dealer clients would have exceeded position limits or accountability levels if the OTC positions had been executed on a US designated contract market (DCM). [A DCM is a board of trade or exchange designated by the CFTC to trade futures or options under the Commodity Exchange Act (CEA)].

Subsequent to gathering the data, CFTC staff issued a report outlining what they uncovered. The report revealed that only a small percentage of swap dealer clients would have exceeded speculative position limits if position limits had applied in the aggregate to all of their positions (including in the OTC markets). Of those that would have exceeded position limits, the amounts by which they would have exceeded them were generally small.

Nevertheless, CFTC staff recommended certain changes that could well indicate the direction of substantial future regulatory changes. The preliminary recommendations were to:

- Improve the CFTC’s weekly Commitments of Traders (COT) Report by incorporating delineated trader classification categories beyond “commercial” and “noncommercial,” which would include designating a separate category for swap dealers.
- Develop and publish a new periodic supplemental report on OTC swap dealer activity, to provide a periodic ‘look through’ from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading.

- Create a new CFTC office of data collection within the Division of Market Oversight, with enhanced procedures and staffing, to collect, verify, audit and publish all of the agency’s COT information.
- Develop “long form” reporting for certain large traders on DCMs to assess more accurately the type of trading activity occurring (including information regarding their underlying transactions).
- Write an advanced notice of proposed rule making that would consider whether to eliminate bona fide hedge exemptions for swap dealers, and create limited risk management exemptions.
- Increase staffing to carry out the proposals.
- Encourage the clearing of all OTC transactions based on the CFTC’s belief that market integrity, transparency and availability of information related to OTC derivatives are improved when these transactions are subject to centralised clearing.
- Review swap dealer commodity research independence. The CFTC noted that, “... many commodity swap dealers are large financial institutions engaged in a range of related financial activity, including commodity market research. Questions have been raised as to whether swap dealer futures trading activity is sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilise existing authorities to conduct a review of the independence of swap dealers’ futures trading activities from affiliated commodity research and report back to the Commission with any findings.”

Changes Already Implemented

The regulated community should view these recommendations as something more than political posturing by the CFTC. To wit, in the summer of 2008, the CFTC increased its regulation over foreign boards of trade (FBOTs) by increasing its oversight over FBOTs that have direct access to US customers (such as ICE Futures Europe and the Dubai Mercantile Exchange). The change was in response to mounting congressional

pressure. FBOs generally operate as exempt markets in the US pursuant to no-action relief granted by the CFTC. However, in July 2008, the CFTC modified the exemptions for ICE and the DME by conditioning their direct access to US customers on their compliance with the following requirements:

- Adoption of equivalent US speculative position limits and accountability rules with respect to contracts that settle on the price of a contract traded on a CFTC-regulated exchange or a significant price discovery contract (SPDC) traded on an exempt commercial market.
- Provision of quarterly report regarding any traders that have positions in a linked contract above the applicable position limit, as to whether a hedge exemption was granted and, if not, whether disciplinary actions were taken.
- Publication of certain daily trading information.
- Provision of daily large trader report.

Notably, the CFTC is the only commodity regulator in the world that actively pursues manipulation in all physical, OTC and futures markets on a daily basis. In comparison, the United Kingdom's Financial Services Authority (FSA) is renowned for having a 'light touch' approach in the derivatives sector and beyond. Although the UK typically viewed less regulation as better for

dependent nature of commodity markets necessitates a coordinated regulatory effort to ensure that regulation of FBOs is effective.

Another step in that direction happened with the recent announcement that the International Organization of Securities Commissions (IOSCO) is now working on new initiatives with the both the FSA, and the CFTC, to study international commodity markets and diverse approaches to supervision. Over the next year, we can probably expect more foreign enforcement cases, coupled with additional pressure on foreign exchanges to adopt similar speculative position limits, reporting and record keeping requirements imposed by their US counterparts.

The SEC has also proposed establishing a formal exchange to trade CDSs. However, many financial participants argue that this would be devastating to the market because it would remove the ability to customise products. At the end of the day, the regulation of CDSs may not affect the CFTC's jurisdiction over commodity swaps, but it will probably set the tone for how all swaps are eventually regulated. Although a new era of market regulation is upon us, the United States cannot risk imposing its hegemonic regulatory views on the world. If it does not carefully coordinate with international regulators, the US markets will face jurisdictional arbitrage and the loss of significant revenues in derivatives trading.

Congressional Proposals

Although all of these proposed and actual steps to expand regulation are substantial, they are more narrowly tailored to the realities of the commodities markets and their market participants than some of the changes proposed in legislation introduced in Congress in the latter half of 2008. These bills often confused speculation with manipulation. To be clear, speculative trading is lawful market behaviour. It adds to the liquidity of markets by fueling the efficient operation of the economic trading engine. If the markets are to serve their traditional purpose (that is, to hedge the risk of price moves for commodity producers and buyers), there must be speculators in the market who are willing to take on that risk. Unlike speculation, manipulation is unlawful trading that creates artificial prices by causing a market to deviate from the normal forces of supply and demand.

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financial market development, since the Northern Rock and other 'melt-downs', it is now planning to introduce new rules that it says could "significantly reshape" banks' business models.

Even prior to the financial crisis, there was widespread support among Democrats in the US to level the playing field between domestic exchanges and FBOs. The perception is that FBOs are generally not subject to aggressive anti-manipulation enforcement by their primary regulator abroad, yet they are allowed to operate in the US under certain limited conditions. Therefore, the CFTC expressed the view that the inter-

The confusion between speculation and manipulation prompted lawmakers to propose some fairly draconian bills in 2008. These bills included Senate bill 3577, *Prevent Excessive Speculation Act* (introduced in Senate on September 25th 2008), and Senate bill 3268, *Stop Excessive Energy Speculation Act of 2008* (introduced in Senate on July 15th 2008) – both making various proposals to reduce or eliminate manipulation or "excessive speculation". In September 2008, the House of Representatives actually passed *The Commodity Markets Transparency and Accountability Act of 2008*, HR 6604, also known as the *Peterson Bill*, which would have placed substantial new restrictions on FBOs. The bill did not become law, but has now been reintroduced in Congress as the *Derivatives Markets Transparency and Accountability Act of 2009*. The general view among government affairs experts is that some version of this bill will pass and change the regulatory structure domestically as well as globally. The latest version of the bill requires a number of structural changes for markets, including a provision that forces the CFTC to prevent 'excessive speculation' by setting Federal position limits for all commodities, which would include not only agriculture, but also energy and metals markets. The bill also gives the CFTC the authority to suspend trading of credit default swaps, and authorises the CFTC to directly

prosecute criminal violations of the US Commodity Exchange Act when the Department of Justice refuses to prosecute the alleged illegal conduct.

One piece of legislation that did become law is the *Food, Conservation and Energy Act of 2008*, which included, as Title XIII, the *CFTC Reauthorization Act of 2008* (CRA). The CRA amended the CEA in various respects, including the requirement for exempt commercial markets (ECMs) that list contracts that serve a "significant price discovery function" to follow certain principles with respect to such SPDCs, including adopting speculative position limits where necessary and appropriate. The CFTC proposed a rule identifying the standards to be used for determining which contracts traded on ECMs constitute SPDCs on December 11th 2008. The CFTC is required to identify the contracts that qualify as SPDCs within 180 days after the final rule takes effect.

Increased Market Regulation

Regulatory changes are already underway. These changes, coupled with the potential for new legislation in Congress, all illustrate that the current financial turmoil resulted in a movement towards increased market regulation. While lower prices took some of the pressure off the CFTC to regulate speculation in commodity markets, calls from the US Congress to regulate all OTC markets are likely to continue to force greater regulatory oversight of largely unregulated OTC derivatives markets. A market-based approach to regulatory oversight no longer has appreciable support. During Gensler's confirmation hearing in front of the Senate Agriculture Committee on February 25th, he offered his support to bring "the whole over-the-counter derivatives market into a regulatory regime".

It is becoming nearly impossible to find anyone in the legislative or executive branches who will speak out publicly in favour of open and competitive markets. The real question has become whether the change will make the exist-

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ing regulatory system stronger, or create an entirely new system that will 'fix' perceived problems – and undoubtedly create new problems for the future. •

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